



March 12, 2004

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Docket No. R-1176
Availability of Funds and Collection of Checks

Dear Ms. Johnson:

The Association for Financial Professionals (AFP) welcomes the opportunity to comment on the Federal Reserve Board's proposed rule to amend Regulation CC and its commentary to implement the Check Clearing for the 21st Century Act (Check 21 Act or Act). The Check 21 Act authorizes the use of a new negotiable instrument called a substitute check. A substitute check is a paper reproduction of an original check that contains an image of the front and back of the original check and is suitable for automated processing in the same manner as the original check. The proposed rule defines the legal and operational requirements that apply to banks handling substitute checks.

AFP represents about 14,000 finance and treasury professionals who, on behalf of over 5,000 corporations and other organizations, are significant participants in the nation's payments system. Organizations represented by its members are drawn generally from the Fortune 1,000 companies and the largest of the middle market companies. According to Federal Reserve statistics, businesses receive the largest share of checks by volume, and are by far the dominant writers and receivers of checks by value. Many of AFP's members are responsible for making and receiving check payments on behalf of their organizations. They thus have a sizeable stake in Federal Reserve regulations governing the check collection system.

By stimulating innovation and automation in check collection practices, Check 21 will bring about wide-ranging changes in the payment system. To help bankers and corporate and consumer end-users understand, adapt to and take best advantage of these innovations, Federal Reserve rules should:

- Foster the continued efficiency and cost-effectiveness of the automated services that banks provide to their customers.
- Clearly explain and provide examples of terms that define the legal and operational consequences of using substitute checks.

AFP's comment letter recommends the following modifications to the Federal Reserve's proposed rules to promote these objectives:

- Industry standards for substitute checks accepted by the Board should retain the integrity of corporate cash management services, incorporate advanced fraud control techniques and require strict adherence to quality measures.
- AFP opposes any provision in the rule that would deny legal equivalence to a substitute check requested by a company specifically to resolve a payment dispute or claim.
- AFP requests that the Board explain the relationship between substitute checks and checks eligible for conversion to ACH debits in order to clarify if and when companies collecting checks are able to choose between creating substitute checks or converting them to ACH debits.
- Payors who receive substitute checks should be afforded the same legal protection against fraud that they have when fraud occurs on their original checks.
- AFP requests additional explanation of the term, "paper or electronic representation of a substitute check," and examples of its use. The uses and legal rights attached to "a sufficient copy of an original check" should also be clarified.

AFP will also provide recommendations dealing with these issues:

- The legal status of an item that purports to be a substitute check but is not
- Warranty against duplicative presentments or returns
- Remotely created demand drafts
- Applicability of other check law to substitute checks
- "Clear and conspicuous" standard for providing disclosures
- Indemnity amount and measure of damages

Industry Standards for Substitute Checks: Impact on Cash Management Services

The proposed rule states that "substitute checks must conform to the generally applicable industry standards for substitute checks set forth in ANS [American National Standard] X9.90 and must be suitable for automated processing in the same manner as the original check." § 229.2(zz), at subparagraph 6 (p. 1493)¹

¹ Page references refer to the Board's Federal Register notice, January 8, 2004.

Industry standards for check specifications, established by the American National Standards Institute's (ANSI) Accredited Standards Committee (ASC) X.9, are used today by all banks nationwide, enabling them to automate check processing and provide cash management services to their business customers. These services include automated account reconciliation, positive pay, and controlled disbursement. The Board should not accept industry standards for substitute checks that would disrupt these automated services.

The Board notes that "ANS X9.90 provides that an image of an original check will be reduced in size when placed on a substitute check. Images of business-sized checks will be reduced to about 65 percent of their original size...."

The Board should explain how the reduced size of the substitute check would impact the services that banks provide to their business customers, especially fraud control services such as positive pay. These services depend on the capture of data located in specific fields on the check. For example, if the location of the payee name is changed, will banks be able to offer payee positive pay?

In addition, the Board should encourage the incorporation of new fraud control techniques into industry standards for substitute checks to replace the special imprinting on original checks that will be lost when the checks are imaged.

Industry standards for image quality for the back of the check should ensure that audit information and indorsements are legible. The strengthened financial controls mandated by the Sarbanes-Oxley Act and the need to combat increasing check fraud require adherence by all parties in the collection and return process to strict image quality standards.

The creation of substitute checks and increased use of imaging will reduce or eliminate float. However, businesses rely on the information about check clearings provided by banks' controlled disbursement services for investment and borrowing decisions. Effective controlled disbursement services depend on early morning presentment. The Board's oversight of the payments system includes the authority to establish presentment times for same-day settlement. The Board's regulations should continue to ensure the integrity of controlled disbursement services, which facilitate the efficient allocation of capital and promote economic growth.

Transfer and Consideration: Use of a substitute check to resolve a claim or dispute

AFP requests that the Board clarify the legal status of a substitute check requested specifically to resolve a claim.

Many companies do not ask their banks to return the originals of their paid checks. Instead, they receive check images on CDs or transmissions of paid check data, which are preferable for storage and research. These electronic images and data are not covered by

the Act. The Board notes that “because a substitute check must be a piece of paper, an electronic file or electronic check image that has not yet been printed in accordance with the substitute check definition...is not a substitute check.” § 229.2(zz), at subparagraph 2 (p. 1492)

With the passage of Check 21, companies assumed that if they requested their bank to provide a specific substitute check to resolve a payment claim or dispute, they would receive a paper item that would be the legal equivalent of the original check and accepted as such in court. However, the definition of “transfer and consideration” in the proposed rule appears to indicate that legal equivalence would not apply in cases where a substitute check was requested only because of a claim or dispute. § 229.2(bbb) (p. 1484)

AFP would oppose that part of the definition of “transfer and consideration” if it would limit coverage under the Act when claims are involved. If this limitation applies, the corporate customer who does not receive the return of original paid checks could not receive a legally equivalent substitute check for use in a court case. The result might be greater corporate demand for paper in the form of substitute checks for all of their paid items.

Legal Framework

The proposed definition of transfer and consideration covers situations in which a bank transfers a substitute check to a person other than a bank and receives consideration, e.g., the right to charge a person’s account, for that substitute check.

We agree with the proposed rule’s general treatment of transfer and consideration to include, respectively, deliveries to non-bank persons and the right to charge the drawer’s account. Receipt of consideration by a bank is necessary for the warranties of § 229.52 and indemnities of § 229.53 to attach (p. 1486). Since a substitute check is not a legal equivalent of the original check unless a bank is deemed to have given the warranties § 229.52, it is a key concept for legal equivalency per § 229.51(a) (p. 1485).

We seek clarification of the limitation in § 229.2(bbb)(2)(ii) (p. 1484) which states that a bank does not receive consideration by transferring a substitute check “solely” in response to a person’s warranty, indemnity, expedited recredit, “or other” claim with respect to a substitute check.

The commentary should clarify that this limitation is not triggered by providing a substitute check in a situation that may (or is even likely to) lead to a claim.²

² This appears not to be as significant an issue with an expedited recrediting claim based on an alleged improper debiting of the consumer’s account for a substitute check. Since such claims are not based exclusively on breach of the § 229.52 warranties, the limitation of § 229.2(bbb)(2)(ii) does not appear to apply. See, also, proposed commentary to § 229.54(a) at paragraph 1 (p. 1498) and other discussion in the recrediting provisions regarding consumers who receive substitute checks only on an occasional basis.

Example

Assume that a corporate customer does not regularly receive paid original checks. The paying bank has agreements with the other banks in the collection chain that provide for the truncation of original checks and the creation of an electronic file sufficient to allow the paying bank to produce substitute checks that would qualify for legal equivalency. The payee of an original check claims that it has not been paid, and the corporate payor requests a substitute check from its paying bank. The paying bank informs the corporate payor that the images are blurry, but the payor asks to receive it in any event.

Litigation ensues between the payee and the corporate payor. Because the corporate payor has no clear paper image of the original check, it is forced to engage in more lengthy and costly discovery to prove that the payee received the original check and that it was indorsed in the name of the payee by an authorized, but dishonest, employee of the payee who then absconded with the proceeds.³ Presumably, the payor would have a warranty claim under § 229.52 against its bank for the increased costs that could have been avoided if a clear image of the back of the check, bearing the indorsement of the authorized person, had been given to the payor.⁴

It would be in the paying bank's interest to assert that the copy was given "solely" in connection with a warranty or "other" claim, particularly since the payor had been informed in advance that the images were blurry. The bank would argue that, accordingly, there was no consideration by operation of § 229.2(bbb)(2)(ii) and no automatic warranty rights that attached.

If the Board did indeed intend to exclude corporate customers who make only "as needed" requests for check copies from the warranty and indemnity provisions, the reasons for this should be made clear and distinguished from those situations when a consumer customer can appear to request a copy on an "as needed" basis for certain expedited recrediting requests.⁵ AFP does not support such a result for non-consumer customers in any event.⁶

An Item that Purports To Be a Substitute Check But is Not § 229.51(c) (p. 1485)

³ In such a case, the indorsement is deemed to be effective against the payee. See, UCC § 3-405(b).

⁴ It would appear from Example "d" provided in the proposed commentary to § 229.53(a), at subparagraph 2 (p. 1497), that there would not be an indemnity claim available. Assuming that there may be a warranty claim, however, it would be useful if Example "d" noted that fact.

⁵ The proposed commentary to § 229.54(a), at subparagraph 1 (p. 1498), has an example where a consumer may be able to pursue an expedited recrediting claim even though the consumer originally received an image statement, but then receives a particular substitute check in response to a request.

⁶ If this was the result, a non-consumer customer with sufficient bargaining power may seek to amend its agreement with its bank to obligate the bank to provide, at a minimum, images of substitute checks in monthly statements so that the limitations of § 229.2(bbb)(2)(ii) could be avoided. Customers without sufficient bargaining power would remain unprotected, however.

The Board proposes that an item that does not have the same MICR line as the original check should be considered a substitute check for certain purposes if it is handled as if it were a substitute check. The Board asks if there are other reasons why an item that is not an accurate representation of the original check should be considered a substitute check.

AFP suggests that it is precisely when the MICR line is correct, but there is another technical defect with an item, that protections are needed most. A correct MICR line will greatly increase the chances that the item will be processed automatically by the paying bank (and any prior collecting bank) without noticing the defect.

Legal Framework

As stated in the rule, an item that meets all of the requirements of a substitute check except for the MICR line requirements of § 229.2(zz)(2) (p. 1484) will be treated as a substitute check for purposes of §§ 229.52 through 229.57. However, it would not be a legal equivalent of the original check because it does not accurately represent all of the information on the front and back of the original check. The Board asks if a check that fails to meet any of the other requirements in § 229.2(zz) should also be treated as though it were a substitute check for these purposes (pp. 1475-76).

Example

Assume that the truncating entity (which may be the reconverting bank or a prior entity) experiences an undetected equipment malfunction for a period of time. As a consequence, an image of the reverse side of every other check is captured. Under the rule as proposed, the reconverting bank that intends to create substitute checks from the data file will fail to do so for half of the items because there is no image of the back of the original check as required by § 229.2(zz)(1) (p. 1484). However, because there is no problem with the MICR line, the items are likely to be processed successfully.

The innocent drawers of such items are left in a state of legal uncertainty, as are the paying banks. After the midnight deadline passes, do the paying banks have any return rights? Are consumers left without expedited recrediting rights? What is such an item for purposes of Regulation CC?

Relation between Substitute Checks and Check Conversion to ACH Debits

AFP requests that the Board clarify the relationship between substitute checks and checks eligible for conversion to ACH debits. ACH rules are established by the National Automated Clearing House Association (NACHA).

The Board's proposed commentary states that "because a substitute check must be a representation of an item that is defined as a check under 229.2(k), a paper reproduction of an image of something that is not a check cannot be a substitute check." § 229.2(zz), at subparagraph 2 (p. 1492)

This would imply that a substitute check cannot be created from an ACH source document, that is, a “check” mailed by a consumer to a lockbox or provided at point of purchase after notice to the consumer that the item will be converted to an ACH debit.

The March 2001 Federal Reserve Commentary to Regulation E states that “the final rule provides that where a consumer authorizes the use of a check for initiating an EFT, the transaction is not deemed to be originated by check. The transaction is covered by Regulation E. Comment e(b)-1(v), as adopted, makes clear that the rule applies whether the check is blank, partially completed, or fully completed and signed....In the context of check conversion, authorization takes place if the consumer engages in the transaction after receiving notice that the transaction will be treated as an EFT.”

Example

Assume that a company that receives large volumes of consumer checks has notified its consumer customers that their checks will be converted to ACH debits when they are received at the company’s lockbox. If these “checks” are considered “source documents” for ACH conversion, the company cannot choose, based on float or other economic factors, between having its bank create substitute checks or converting the checks to ACH debits. The company would not have the option of creating substitute checks unless it specifically omitted that group of customers from the conversion notification.

Corporate checks

The proposed rule would also seem to imply that a substitute check can be created from a business check received at a lockbox or at a point of purchase because the business check is not eligible for conversion to an ACH debit under NACHA rules and, therefore, is not a source document.

However, business checks are eligible for conversion to ACH debits under U.S. Treasury Department rules.

The Board should define “an image of something that is not a check,” its relation to check conversion to ACH debits, and its applicability to the differing rules of NACHA and the U.S. government.

Warranty against Duplicative Presentments or Returns § 229.52(a)(2) (p. 1476)

A bank that transfers, presents or returns a substitute check provides a warranty that no person “will be asked to make a payment based on a check that it already has paid.” In some situations, the duplicate payment might take the form of an ACH debit created using information from an original or substitute check. The Board requests comment on whether using information from a substitute check to create an ACH debit entry should be considered a duplicate payment request covered by this warranty (p. 1476).

AFP recommends that the warranty against duplicate payments apply to ACH debits. It is not clear that there is a right to return the ACH debit entry through the ACH network when the duplicative debit relates to a substitute check as opposed to the original check,

particularly if the substitute check does not meet the legal equivalency requirements, since the ACH return rules are written to cover only duplicative presentment of the original check.⁷

Legal Equivalence and Applicable Law in Fraud Situations § 229.51(a & d) (p. 1485)

AFP recommends that the Board include one or more examples in the commentary to § 229.51 (pp. 1495-96) to explain how the concept of legal equivalence and applicable law would apply to substitute checks in fraud situations. The Board should afford payors who receive substitute checks the same legal protection against fraud that they have when fraud occurs on their original checks.

Example

Assume that an original check is made payable to “John Doe” and is mailed by the drawer to John Doe. The original check is intercepted by a thief and the payee’s name is altered to read “John Smith.” The thief endorses and negotiates the original check, as altered, and a substitute check is subsequently created. Is there a “substitute check” for purposes of the rule? It would appear that the rule would consider the altered check to be a “substitute check.” The language of § 229.51(a) (p. 1485) and the proposed commentary at subparagraph 3 (p. 1495) states that a substitute check is an item that accurately represents all of the information on the front and back of the check *as of the time* the original check is truncated.

Had the original check, as altered, been presented to the paying bank and debited against the drawer’s account, the UCC clearly provides the drawer with significant rights. The drawer would have a claim against its bank for paying an item that was not “properly payable” under UCC 4-401, and the paying bank would in turn have a presentment warranty claim under UCC 4-208(a)(2) against the bank of first deposit concerning the alteration. The same claims should be fully available to the drawer and the paying bank for the substitute check. An example in commentary should be added accordingly.

Definition of a “Paper or Electronic Representation” of a Substitute Check § 229.52 and others

AFP requests that the Board explicitly define the term, “paper or electronic representation of a substitute check,” and clarify by providing examples of its use.

In numerous provisions of the proposed rule, the Board makes reference to “a substitute check or a paper or electronic representation of a substitute check.” This “paper or electronic representation” is covered by the same warranties and indemnities as the

⁷ NACHA Operating Rules governing the receiver’s right to recredit are found in Subsection 7.6.2 for POP entries and Subsection 7.6.4 for ARC entries and apply to the duplicative presentment of source documents. Source documents are defined in Subsections 3.6.2 (ARC) and 3.7.1 (POP), as original checks presented by the drawer. So if a substitute check is not the legal equivalent of the original check, it does not appear that the receiver has a clear right to use the NACHA recredit rules in the case of duplicative presentments.

substitute check. How is a paper representation of a substitute check different from a substitute check?

Moreover, the explanation of this term in the proposed commentary appears inconsistent. The commentary to § 229.52(a), in the last sentence of subparagraph 1 (p. 1496), states that a paper representation of a substitute check could include an image of a substitute check contained within an image statement. However, the proposed commentary to § 229.2(zz), the last sentence of subparagraph 6 (p. 1493), states that such images are not substitute checks because they are not MICR-encoded and are not suitable for automated processing as are original checks.

“Because a substitute check must be a piece of paper,” § 229.2(zz), at subparagraph 2 (p. 1492), and electronic files are not included under the Check 21 Act, please clarify why the commentary states that a paper representation of a substitute check could include information about the check (e.g., check number and amount) on an account statement? § 229.52(a), at subparagraph 1 (p. 1496).

Definition of a “Sufficient Copy” § 229.2(aaa) and others

AFP requests that the Board explain the various uses of “a sufficient copy of an original check” and associated legal rights as distinguished from the rights associated with substitute checks.

A sufficient copy is defined in the proposed rules as a “copy of an original check that accurately represents all of the information on the front and back of the check as of the time it was truncated or that otherwise is sufficient to determine the validity of the relevant claim.” § 229.2(aaa) (p.1484)

It appears that a bank can produce a sufficient copy of the original check to limit the amount of its indemnity payment to the recipient of a substitute check who incurs a loss. § 229.53(3) (p. 1486) What are the legal rights of the drawer who holds a sufficient copy of the original check?

Remotely Created Demand Drafts

Although not specifically related to the Check 21 Act, the Board requests comment on whether to incorporate into Regulation CC revisions to the liability for remotely created consumer items (p. 1482). These revisions were recently added to the model Uniform Commercial Code (UCC) but have not yet been widely adopted by the states.

Remotely created consumer items are drawn on consumers’ accounts but they do not have the consumer’s handwritten signature. They are created by a third party (other than the consumer’s bank) to debit a consumer’s account. They have sometimes been used in cases of check fraud or deceptive sales practices.

The UCC revisions “would require a person who transfers a remotely created consumer item to warrant that the person on whose account the item is drawn authorized the issuance of the item....” This would shift liability from the paying bank to the depository bank whose customer created and deposited the demand draft.

AFP is unable to state whether it would be in favor or opposed to incorporating this UCC revision into Regulation CC because of many unanswered questions in this area, initially focused on how the warranties would be enforced. Would the Federal Reserve have jurisdiction over the non-bank persons who create demand drafts? Would a paying bank asserting this warranty right against the bank of first deposit have a private cause of action that would allow direct suits? Would suits have to be brought in federal court or in state court (where, perhaps, a less costly small claims process may be available)?

We believe that if the Board wishes to pursue this further, it would be appropriate to issue a separate proposal for public comment.

Applicable Law §229.51(d) (p. 1485)

There are several examples in the proposed commentary concerning the applicability of other check law to substitute checks. As one example, the proposed commentary to § 229.52(a), at subparagraph 3 (p. 1496), states that a reconverting bank does not affirmatively need to make the substitute check warranties because they attach automatically when the bank transfers the substitute check (or a representation thereof) for consideration. The comment goes on to state that because such a check is warranted to be the legal equivalent of the original, it is “thereby subject to existing laws as if it were the original check, [and] all UCC and other Regulation CC warranties that apply to the original check also apply to the substitute check” (p. 1496). While we agree that this should be the result, we do not believe that the language of proposed § 229.51(d) (p. 1485) would lead to this result in all cases.

Continuing the above example from the proposed commentary, assume that the substitute check at issue meets the technical terms of § 229.2(zz) (p. 1484), but it does not meet the technical terms for legal equivalence in § 229.51(a) (p. 1485). It has an “image” of the front of the original check as called for in § 229.2(zz)(1), but the image is blurry and is not an “accurate” representation of the front of the check as called for in § 229.51(a)(1).⁸ Because the item would not qualify for legal equivalence under § 229.51(a), it would not appear to be covered by the applicable law provisions of § 229.51(d).⁹

⁸Or, for whatever reason, the legend has been programmed incorrectly and omits a word from the mandated language of § 229.51(a)(2).

⁹ This does not appear to be a problem for Regulation CC coverage as shown through the proposed revision of the commentary to the definition of “check.” See 69 Fed. Reg. at 1491 (substitute check that does not meet legal equivalency standard is nonetheless stated to be a “check” for Regulation CC purposes). It is not clear why there is a carve-out for purposes for Regulation CC coverage, but not for any other laws or regulations.

The applicable law provision in the proposed rule is taken almost verbatim from § 4(e) of the Act. AFP is concerned that this provision is overly narrow, and we urge the Board to exercise its authority under § 15 of the Act to prescribe regulations that are necessary to implement the Act and its key goal of placing persons whose original checks are processed through the use of substitute checks in no worse position than they would be had substitute checks not been used.

We are concerned that, at a minimum, a court could read § 229.51(d) (p. 1485) as creating the implication that **only** those substitute checks that meet the legal equivalence standard are to be treated as “checks” under the UCC and other laws, but that substitute checks that fall short of legal equivalency and items that do not qualify as substitute checks for technical reasons should not be afforded this deference. The implication is reinforced by § 229.51(c) on purported substitute checks since such checks are pointedly made subject to §§ 229.52 through 57, but are left out of coverage under § 229.51(d). Such a result could open the handling of the items to the assertion of common law rules that the UCC was intended to supercede and that no party had in mind as the item was passing through the collection system.

“Clear and Conspicuous” Standard for Providing Disclosures Proposed Commentary to § 229.15(a) (p. 1494)

In the commentary to § 229.15(a), the Board proposes to revise current language regarding the depository bank’s duty to make disclosures required under Subpart B of Regulation CC in a “clear and conspicuous manner.” The Board would add a cross reference to examples contained in § 216.3(b)(2) of Regulation P (p. 1494). The Board has proposed similar changes for disclosure standards contained in other regulations—specifically Regulations B, E, M, Z, and DD—as reflected in proposed rules published in the Federal Register, December 10, 2003.

We believe that it is appropriate for the Board to follow a similar process for changes to Regulation CC, so that they may be evaluated and commented on separately. We believe it is appropriate from an efficiency and cost perspective to implement any changes to the disclosure standards of Regulation CC at the same time and in the same manner as the other regulations, particularly Regulation DD, which also deals with deposit account documents and disclosures.

Indemnity Amount and Measure of Damages §§ 229.53(b) and 229.56(a) (pp. 1486 & 1488)

The proposed commentaries to §§ 229.53(b)(1)(i), 229.53(b)(1)(ii), and 229.56(a) (pp. 1497-98 and 1500) would benefit greatly from several detailed examples of potential differences in the measure of damages among these provisions. For example, how does “interest and expenses (including costs and reasonable expenses of representation) related to the substitute check” (as referred to in §§ 229.53(b)(1)(ii)(B) and 229.56(a)(1)(ii)) differ from “any loss (including interest, costs, reasonable attorney’s fees, and other

expenses of representation) proximately caused by the warranty breach” (as referred to in § 229.53(b)(1)(i))?

It also appears that a person who only has a warranty claim (but not an indemnity claim) must look exclusively to § 229.56(a) (p. 1488) to determine recoverable damages. On the other hand, it appears the damage provisions § 229.53(b) (p. 1486) are available only to a person that has an indemnity claim (i.e., a loss that occurs due to the receipt of a substitute check instead of the original check). Then, for such persons with indemnity claims, the damage provisions of § 229.53(b)(1)(i) are used if the indemnity claim also involves a breach of warranty, and the damages of § 229.53(b)(1)(ii) are used if there is only an indemnity claim.¹⁰ Again, clear examples in the commentary in this area are needed.

AFP thanks the Board for the opportunity to comment on the proposed rules for Check 21. If you have any questions about this comment letter, please call Arlene Chapman of AFP at 301-961-8825.

Sincerely,



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¹⁰ In the proposed commentary to § 229.56(a), the last sentence in subparagraph 1 (p. 1500) (regarding recovery under § 229.53 if a person received a “problematic substitute check” or under § 229.56 if not) is particularly confusing and should be deleted or substantially revised.